United States Court of Appeals

for the Second Circuit

APPELLANT’S REPLY BRIEF

76-7178

United States Court of Appeals
FOR THE SECOND CIRCUIT

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P/S

Docket No. 76-7178

FRANKLIN SAVINGS BANK OF NEW YORK,
Plaintiff-Appellee,

—against—

GUSTAVE L. LEVY, *et al.*,
Defendants-Appellants.

REPLY BRIEF FOR APPELLANTS

UNITED STATES COURT OF APPEALS
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REPLY BRIEF FOR APPELLANTS

Franklin's somewhat discursive brief consists largely of a review and summary of its post-trial memorandum to the District Court, and proceeds without substantial discussion of either Judge Metzner's decision or the particular points of error assigned by Goldman, Sachs on this appeal. For this reason, this reply attempts to refocus upon the actual errors which we believe require reversal.

I.

Franklin Has Failed To Establish Jurisdiction Under The Securities Exchange Act of 1934 or The Securities Act of 1933.

A. The 1934 Act

The trial court concluded that the Penn Central commercial paper sold to Franklin was a security for purposes of the 1934 Act largely on the basis of this Court's decision

in *Zeller* v. *Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied,* 414 U.S. 908 (1973). Whether *Zeller* be interpreted as implying a "four ply test" or some more generalized standard, the basis for the trial court's opinion is clear: it concluded that the commercial paper of Penn Central sold to Franklin was not "prime" and, for that reason alone, that the note in question was a security. 406 F. Supp. at 44, 46, (1457a, 1459a).

Franklin appears to concede that the interpretation of legislative history upon which the *Zeller* Court found an identity between § 3(a)(3) of the 1933 Act and § 3(a)(10) of the 1934 Act is erroneous—at least to the extent of recognizing that the comments in Senate Report No. 792* were made with reference to an earlier draft of § 3(a)(10). Unlike the final version, that draft was indeed identical to the 1933 Act exemption found in § 3(a)(3). Accordingly, the rationale of *Zeller*—that the 1934 Act definition should be interpreted in light of the SEC's gloss upon the 1933 Act exemption—is based upon an improper equation of the two sections. Since there is no basis for imposing a criterion of "prime" except by invoking the SEC's interpretation of § 3(a)(3), the rationale of *Zeller* is thus undercut.

Equally significant is the fact that § 3(a)(3) of the 1933 Act does not itself provide any "four ply test" and certainly contains no reference to "prime" commercial paper—a notion derived solely from SEC Securities Act of 1933 Release No. 4412, 26 Fed Reg. 9158 (Sept. 20, 1961). Section 3(a)(3) exempts notes only on the basis that they have a maturity not in excess of 270 days and that they arise out of "current transactions." This absence of any

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* S. Rep. No. 792, 73d Cong., 2d Sess. 14 (1934) (cited in *Zeller,* 476 F.2d at 800 n.7).

statutory criterion of "prime" must be measured against the logic of *Ernst & Ernst* v. *Hochfelder,* 96 S. Ct. 1375 (1976).

In *Ernst & Ernst,* the Supreme Court held specifically that the requirement of manipulative intent could not be read out of § 10(b) of the 1934 Act by the Commission's imposition of a negligence standard supposedly in keeping with some broad but undefined "remedial" purpose of the statute. *Id.* at 1384. That rationale applies directly here. The SEC's imposition of the additional requirement of "prime" does not appear at all in § 3(a)(3) and, more fundamentally, is contrary to the entire thrust of Congressional intent in passing the securities laws, which was to empower an agency to pass upon disclosure requirements but not the relative desirability of various investment vehicles. *See, e.g.,* FTC Securities Act of 1933 Release No. 1, May 27, 1933.

For federal courts to carry this regulatory zeal yet another step and import the SEC's misinterpretation of a section of the 1933 Act into the 1934 Act compounds the error. As the Court of Appeals for the Third Circuit recently held, "[T]he unmistakable mandate of *Ernst & Ernst* v. *Hochfelder* . . . is that the courts must apply each section of the Securities Exchange Act with precision." *Straub* v. *Vaisman & Co.,* CCH Fed. Sec. L. Rep. ¶ 95,623, at 90,111 (3d Cir. June 15, 1976).*

Not only is the imposition of a criterion of "prime" inappropriate for the reasons based on legislative history set forth in our initial brief, but in any event, the applica-

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* *See Burrus, Cootes & Burrus* v. *MacKethan,* CCH Fed. Sec. L. Rep. ¶ 95,664, at 90,270-71 (4th Cir. July 23, 1976). In that case, the Court specifically observed that the certificate of deposit in question was "far more like commercial paper than any other obligation," and proceeded to hold that the instrument was not a security under § 3(a)(10).

tion of that supposed criterion to the note sold to Franklin was erroneous. At trial Goldman, Sachs presented substantial evidence that it made a careful investigation and analysis of Penn Central and at all times concluded that Penn Central was creditworthy as that term is used in the commercial paper business. That testimony was essentially unchallenged, and Franklin offered no testimony of its own on the point. The trial court's opinion does not take issue with any aspect of Goldman, Sachs' credit analysis. And indeed, there is simply no evidence that Goldman, Sachs' credit work with respect to Penn Central was in any way inadequate.

It is therefore difficult to comprehend how—unless a standard of absolute liability has been imposed—the court was able to find that the commercial paper was not "prime" at the time of sale. The trial court apparently imposed, *sub silentio,* a test which was not dependent upon reasonable investigation and analysis but upon some abstract and undefined notion of "prime"—a test which despite the trial court's protestations can only be explained as having been made with the benefit of hindsight based upon Penn Central's subsequent filing for reorganization.

Finally, to the extent Franklin relies upon this Court's decision in *Exchange National Bank of Chicago* v. *Touche Ross & Co.,* CCH Fed. Sec. L. Rep. ¶ 95,614 (2d Cir. June 9, 1976), its reliance is misplaced. *Exchange National* recognized that the context may require that an instrument literally *within* the statute not be treated as a security. It does not say, however, that an instrument literally *excluded* may be brought within the statute. On the contrary, Judge Friendly specifically observed:

> "So long as the statutes remain as they have been for over forty years, courts had better not depart

> from their words without strong support for the conviction that, under the authority vested in them by the 'context' clause, they are doing what Congress wanted when they refuse to do what it said."

Id. at 90,064.

Here, Congress excluded notes with a maturity of not more than 270 days, and there is no reason to depart from the clear words of the statutory definition.

B. The 1933 Act

In its initial brief on appeal Goldman, Sachs argued that the uses of the mails upon which the trial court relied are an insufficient basis for establishing subject matter jurisdiction under the 1933 Act. Franklin responded largely by emphasizing *United States* v. *Cashin,* 281 F.2d 669 (2d Cir. 1960), upon which the District Court also relied.

There was in *Cashin,* however, no challenge to subject matter jurisdiction, and the statement of the Court there was made solely by way of argument in support of permitting venue in the district where wrongful acts other than use of the mails allegedly occurred. The *Cashin* Court was not attempting to delimit the outer bounds of subject matter jurisdiction, and its language should not be taken as a definitive ruling on that subject.

Although cases are cited by Franklin in which jurisdiction was founded upon mailings that were not central to plaintiff's scheme, in none was the after-the-fact use of the mails as remote as in the case before this Court. To the extent those cases rely upon mailings after the fact, each shows that such mailings were made in furtherance of a continuing scheme by the defendant or were necessary to

the completion of the transaction in question.* In particular, it should be noted that in *United States* v. *Wolfson*, 405 F.2d 779, 784 (2d Cir. 1968), *cert denied*, 394 U.S. 946 (1969), this Court, while grounding jurisdiction upon the mailing of a confirmation, took care to note that the item mailed was "essential to a valid sale." This is not the case in the commercial paper market. *Compare* UCC § 8-319(a) & (c), *with id.* § 8-319(b).

II.

The Trial Court Erred In Imposing Liability On The Merits On Franklin's 1933 and 1934 Act Claims.

Franklin's discussion of the merits commences with a list of "facts" which it deems important. No effort is made to analyze how the District Court reached its own conclusions and to what extent it relied on the "facts" stated. Indeed, Franklin's brief simply attempts to impose its own structure—first adopted in its post-trial memorandum—and ignores the trial court's conclusions which are the proper subject of this appeal.

This section of appellants' reply will consider briefly plaintiff's arguments in order to refocus the attention of

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* *Welch Foods Inc.* v. *Goldman, Sachs & Co.*, 398 F. Supp. 1393 (S.D.N.Y. 1974), is superficially an exception to this proposition. *Welch*, another of the Penn Central commercial paper cases brought against Goldman, Sachs, involved a jurisdictional challenge to an intrastate transaction analogous to that now before this Court. The *Welch* case was settled pending appeal, and thus the issue has not before been considered in this Court. In any event, Welch was located outside New York City in upstate New York. The potential use of the mails was far more likely there than in the case of a transaction between two New York City banks in a market customarily operated in the city by hand delivery and without use of the mails.

this Court upon the erroneous findings and procedures of the District Court. Space does not permit the lengthy reargument—which Franklin's brief invites—of facts not specifically relied upon by the trial court opinion. We therefore respectfully refer this Court to our post-trial briefs for a more complete analysis of the trial record and a refutation of Franklin's factual contentions.

Franklin considers the trial record under three headings: "liquidity," "bank lines" and "inventory decisions." Each will briefly be considered in turn.

Liquidity

Franklin argues that liquidity—by which it apparently means cash availability for repayment of commercial paper —is important and that facts regarding liquidity should have been conveyed to Mr. Bock, President of Franklin. The trial court reached no such conclusion. In fact it discussed the cash needs of Penn Central as a rather routine subject, pointing out that plans had been made to raise the necessary cash and that those plans were well under way at the time of plaintiff's purchase. 406 F. Supp. at 45 (1458a).*

The reason that Judge Metzner did not rely upon any alleged failure to communicate information regarding "liquidity" is clear from the record—Mr. Bock was fully aware of Penn Central's cash situation.

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* Franklin's brief repeats the blatant misstatement of the record which appeared in its post-trial memorandum, namely that David Bevan, Chairman of the Finance Committee of Penn Central, stated to Goldman, Sachs on February 6 ,1970 that although the budgeted first quarter loss was $49 million, the actual loss would exceed that amount by $6 or $7 million. Far from supporting that assertion, the testimony cited by plaintiff includes the specific statement, *"I didn't tell them this."* (Bevan Dep. 1441a) (emphasis added).

> Q. There is no doubt that it was public knowledge that they were pinched for cash, is there?
> A. That's correct.

(Bock, Tr. 233a). *Accord,* 406 F. Supp. at 46 (1459a).

Bank Lines

Franklin next claims that certain conversations regarding Penn Central's bank lines of credit should have been disclosed to Mr. Bock. Although the trial court's opinion discusses bank lines at several points, it never suggests that information regarding bank lines should have been conveyed to Mr. Bock. Once again the reason for this is undoubtedly Bock's own testimony bearing upon the materiality of information regarding bank line coverage:

> The Court: . . . Let me understand this. You say you never inquired as to whether there was any bank line of credit against Penn Central commercial paper; is that correct?
> The Witness: I have never made an inquiry of Goldman, Sachs as to whether or not there was complete coverage of bank lines of credit. . . .
>
> * * *
>
> The Court: You weren't really interested in whether there was a bank line of credit, were you?
> The Witness: That was not a cardinal yard stick out of all the others that I can think of here.

(Bock, Tr. 273a). *Accord,* 406 F. Supp. at 46 (1459a).

In addition to Franklin's own evidence of the immateriality of bank lines, the testimony shows that a bank line was merely an indication of willingness to lend money in the future—assuming that the bank involved continued to be satisfied with the creditworthiness of the potential borrower. (Sullivan, Tr. 877a; Vogel, Tr. 681a; Van Cleave,

Tr. 420a). Two bankers were called at trial. One was Mr. Bock of Franklin who testified, as indicated above, that bank lines were not of cardinal importance to him. The other was John J. Sullivan, a senior vice president of Manufacturers Hanover Trust Company, and the senior leading officer responsible for Penn Central during the relevant time period. Sullivan testified as follows:

> Q. Will you state for the Court, please what is meant by the term "line of credit"?
>
> A. The line of credit is an availability, a facility available from a bank to a borrower, to lend usually during the coming year and usually for current needs.
>
> Q. As a matter of custom and practice does such a letter contain any conditions?
>
> A. In our bank we state that the line of credit is subject to our satisfaction with the financial condition of the borrower.
>
> * * *
>
> Q. When you define line of credit to refer to that kind of an extension of a facility, is that generally true among lending commercial banks?
>
> A. Yes.

(Sullivan, Tr. 877a, 879a).

Thus although bank lines are considered useful because in ordinary times they allow flexible financial planning, the fact that they are cancellable in time of real financial difficulty makes it dangerous to look upon them as the commercial paper insurance Franklin seems to suggest.

Inventory

Of all the distortions of fact that permeate Franklin's brief, perhaps the most pernicious is its assertion that in February 1970 Goldman, Sachs developed a plan, which was still in the process of consummation at the time of Franklin's purchase in March, to eliminate all Penn Central commer-

cial paper from its inventory. Franklin offers no record support for this proposition and indeed there is none. On the contrary, the evidence is that Goldman, Sachs reduced but did not eliminate its inventory in February or March and made no affirmative decision to eliminate its inventory at least until well after plaintiff's purchase—if ever.

The most telling support of Goldman, Sachs's position on this point—a fact completely ignored by Franklin although it is established by undisputed statistical evidence—is that Goldman, Sachs' inventory of Penn Central commercial paper reached zero on February 25, 1970 and remained at that level through March 1, 1970. It then rose to $9,000,000 on March 2 and thereafter continued its erratic course until well after Franklin's March 16 purchase. (Ex. CW, 1405a-10a). If Goldman, Sachs had planned in February to eliminate its inventory and not to hold Penn Central commercial paper thereafter, why did it allow inventory to build up again after its elimination on February 25? Franklin has offered no satisfactory explanation of this phenomenon and indeed there is none—except that Goldman, Sachs' inventory reductions in April were wholly unrelated to the decisions made in February and March.*

Citing *Chasins* v. *Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970), Franklin also asserts that the reduction in inventory in February was itself a fact which ought to have been disclosed because it might have borne upon Franklin's assessment of Goldman, Sachs' good faith.

As indicated in our initial brief, this aspect of *Chasins* cannot survive *Ernst & Ernst* v. *Hochfelder*, 96 S. Ct. 1375

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* Goldman, Sachs' Blue Sheet of March 23, 1970, Ex. F-5 (1306a), confirms the continuation of the $5 million inventory limitation and contains no mention of any further reduction in inventory. Thus, plaintiff itself offered significant corroborating evidence of Goldman, Sachs' adherence to a policy of carrying inventory even after the March 16 purchase by Franklin.

(1976), and *TSC Industries, Inc.* v. *Northway, Inc.*, 96 S. Ct. 2126 (1976), which respectively reassess the requirement of *scienter* under Rule 10b-5 and the definition of materiality. Of particular significance is the conclusion in *TSC* that a fact which may give rise to an inference of wrongdoing is not material and need not be disclosed if it can be demonstrated at trial that the inference of wrongdoing would not be proper:

> The Court of Appeals' approach would sanction the imposition of civil liability on a theory that undisclosed information may *suggest* the existence of market manipulation, even if the responsible corporate officials knew that there was in fact no market manipulation. We do not agree that Rule 14a-9 requires such a result. . . . If, as we must assume on a motion for summary judgment, there was no collusion or manipulation whatsoever . . . that is, if the purchases were made wholly independently for proper corporate and investment purposes, then . . . they had no bearing on the soundness and reliability of the market prices listed in the proxy statement, and it cannot have been materially misleading to fail to disclose them.
>
> . . . [I]f liability is to be imposed in this case upon a theory that it was misleading to fail to disclose purchases suggestive of market manipulation, there must be some showing that there was in fact market manipulation.

96 S. Ct. at 2139-40 (footnotes omitted). Unless Franklin shows that the inventory reduction was made with an improper motive, it will not have met its burden of establishing the materiality of facts regarding inventory.*

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* In response to this argument Franklin cites *SEC* v. *Shapiro*, 349 F. Supp. 46, 54 (S.D.N.Y. 1970). *Shapiro*, however, held only that where there is *no* persuasive explanation of a transaction

Evidence supporting the proposition that Goldman, Sachs' decision to reduce Penn Central inventory was an ordinary business judgment is manifold. Moreover, as discussed in our initial brief, the trial court's misinterpretation of that evidence—particularly its inaccurate finding that no other inventory was ever reduced by Goldman, Sachs—was clearly erroneous.

In its brief, Franklin largely ignores that challenged finding and instead rehashes evidence on separate though related points. In particular, Franklin focuses upon a Goldman, Sachs report on the cost of carrying inventory that was written during the Fall-Winter of 1969. (Ex. F-56, 1332a-47a). In an apparent attempt to undermine this exhibit (which was offered in evidence by Franklin), it is argued that the Report was never adopted formally by the Management Committee of Goldman, Sachs. It is undisputed, however, that the Report was written by senior personnel of the commercial paper department and reflected their views during the winter of 1970. (Van Cleave, Tr. 412a-13a, 418a). The Report states—unequivocally and in some detail—that the costs of carrying inventory were high, were increasing, were cutting into the profitability of the commercial paper department and ought to be controlled by the reduction or elimination of Goldman, Sachs' inventory positions. (*See* Ex. F-56, p. 5, 1340a).

(footnote continued from preceding page)

other than the juxtaposition of non-public information with an investment decision, an inference may be drawn that the one affected the other—*res ipsa loquitur*. That inference ought not to be an irrebuttable presumption, however, and nothing in *Shapiro* suggests that it is. Here the inference, if any, has been fully rebutted by Goldman, Sachs' evidence that the reduction in inventory was the culmination of a long series of negotiations and discussions with Penn Central and was logically dictated by events and circumstances apart from any suggestion of fear on the part of Goldman, Sachs that Penn Central was not creditworthy. Accordingly, by the rationale of *TSC,* 96 S. Ct. 2126, the reduction need not have been disclosed.

Franklin also argues that because blue sheet memoranda in February 1970 do not discuss the costs of inventory such costs could not have motivated Goldman, Sachs' decision. As is apparent from even a cursory review of the blue sheets, however, their purpose is to report the substance of conversations with issuers and not to provide an opportunity for general exegesis upon Goldman, Sachs' policies. Because blue sheets were written for those who were fully aware—*inter alia* by virtue of the existence of Exhibit F-56—of the cost of inventory, no inference can fairly be drawn from their failure to mention the obvious. Moreover, if Franklin seeks prior consistent statements that the inventory of Penn Central was objectionable for cost reasons, this can be found in the testimony of Raymond Lepley, Assistant Treasurer of Penn Central, to whom complaints about the cost of inventory were directed as early as November 1969. (Lepley, Tr. 918a-19a).

Finally, Franklin turns its attention to the central finding of the court below—that "no other inventories were reduced by Goldman, Sachs in this manner." As shown in Goldman, Sachs' memorandum in support of its motion for a new trial and in its initial brief before this Court, that finding is clearly erroneous. The testimony of George Van Cleave at trial that there were other instances of returns of commercial paper from inventory (Van Cleave, Tr. 513a) is absolutely uncontradicted on the record—and yet the Court found precisely the opposite.

The trial record also includes specific evidence of two other inventory returns. First, Goldman, Sachs had previously returned Penn Central paper from inventory in December of 1969 in a transaction far removed in time from any disclosure—public or nonpublic—of adverse financial information about Penn Central. (Ex. CW, 1405a-10a; Van Cleave, Tr. 457a). Second, a similar return from

inventory of the paper of Avco Delta Corporation was also proven. (Exs. EV, 1411a and EW, 1412a). In addition, as part of our motion for a new trial, we offered for the consideration of the trial court the testimony of Robert Wilson, head of the commercial paper department, given in *University Hill Foundation* v. *Goldman, Sachs & Co.*, 71 Civ. 1166 (MEL) (S.D.N.Y.), a case tried before the decision in *Franklin,* in which returns from inventory were discussed in relation to Avco Corporation (a separate entity from Avco Delta) and The Dow Chemical Company. (*See* 1492a-1529a).

Franklin's brief simply ignores Van Cleave's testimony and the offer of proof from *University Hill* and dismisses the Avco Delta and December Penn Central reductions as isolated instances. Be that as it may, even isolated examples of reductions—particularly in conjunction with Van Cleave's general statement—are proof of the trial court's error. In this regard it is again worthy of note that where evidence of other returns from inventory were offered, another court faced with the same question regarding the return from inventory, concluded "as stated in the findings above, the court after hearing the evidence finds that there was no action undertaken by the defendant Goldman, Sachs to deceive, manipulate or defraud the plaintiff." *Alton Box Board Co.* v. *Goldman, Sachs & Co.*, 71 C. 185(3) (E.D. Mo., filed June 10, 1976). (Wangelin, J.).

The 1933 Act

Near the end of its brief, Franklin turns at last to the law governing this appeal. Ignoring the progression of argument adopted by the District Court, Franklin first presents argument on liability under § 12(2) of the 1933 Act.

Franklin's argument is notable first for the fact that it does not cite a single case decided under § 12(2). With the exception of one case decided under § 11 of the 1933 Act,

each of the cases cited by Franklin was decided under Rule 10b-5, and the failure to distinguish between liability under the two provisions is symptomatic of Franklin's misunderstanding of Goldman, Sachs' position and of the law.

Unlike Rule 10b-5, § 12(2) imposes liability only for the making of material untrue statements or statements rendered misleading by the omission of material facts. *Trussell* v. *United Underwriters Ltd.*, 228 F. Supp. 757, 762 (D. Colo. 1964). *See* Brief for Appellants at 45 & n.* and cases there cited.

Recognizing this distinction, the trial court based its one-sentence holding under § 12(2) solely upon omissions which supposedly rendered misleading Goldman, Sachs' expression of an opinion as to the creditworthiness of Penn Central commercial paper. 406 F. Supp. at 47 (1460a).

The trial court's decision, however, contains no finding—and the record contains no evidence—that Goldman, Sachs' opinion was negligently or unreasonably held. Accordingly, the court's conclusion can only be based upon its inference regarding the motivation for Goldman, Sachs' inventory reduction. The decision under § 12(2), then, stands or falls with the broader findings of the trial court under Rule 10b-5 considered hereafter.

The 1934 Act

In our initial brief we argued that the trial court's decision and the conduct of the trial itself indicated a failure to consider the element of *scienter* which is requisite for liability under Rule 10b-5. Specifically, we argued that Judge Metzner made no explicit finding of *scienter* and that his exclusion of evidence of Goldman, Sachs' good faith coupled with his remarks that he did not "need it for this

trial" (Tr. 810a) indicated that he did not view Goldman, Sachs' intent as a relevant issue.

In light of the decision of the United States Supreme Court in *Ernst & Ernst* v. *Hochfelder,* 96 S. Ct. 1375 (1976), it is apparent that the omission of findings on this critical element requires, at the least, that the case be remanded for further consideration by the trial court.

Franklin's brief ignores these arguments, devotes only half of a sentence to *Ernst & Ernst* and dismisses Goldman, Sachs' position by characterizing it as a demand that Judge Metzner have used "the magic words 'intent to defraud.' "

Goldman, Sachs, of course, makes no assertion that any incantation of a particular phrase is requisite to liability. We do say, as did the Supreme Court in *Ernst & Ernst,* that a finding of *scienter* is required. For the reasons set forth in our initial brief to this Court, Goldman, Sachs believes no such finding was made. Moreover, the absence of any analysis whatsoever of the trial court's decision in this regard in Franklin's brief to this Court stands as a virtual admission of the trial court's failure.

Instead of any analysis responsive to Goldman, Sachs' arguments, Franklin merely lists in cryptic form facts which it apparently believes might lead some court to infer the necessary *scienter.* It is respectfully submitted that it is not the function of this Court to analyze those asserted facts to determine whether or not a trial court, having seen and heard the relevant witnesses, could have or should have found *scienter.*

Several of the alleged facts are inaccurately stated and some are conclusory assertions rather than facts at all. In any event, whether taken together or separately, they present no coherent picture of evil motive such as is required

by *Ernst & Ernst* and the prior cases in this Circuit. Accordingly, the finding of liability under Rule 10b-5 cannot stand.

Appellants' Evidentiary Points

Franklin's final arguments relate to the evidentiary issues raised by Goldman, Sachs on appeal. The bulk of argument is devoted to evidence regarding the significance of Brown Brothers, Harriman's removal of Penn Central from its "approved list" in February 1970.

At the outset it should be noted that Franklin entirely ignores the premise of Goldman, Sachs' argument, namely, that the trial court held that Brown Brothers' actions were irrelevant and thereby induced Goldman, Sachs not to present evidence it would otherwise have offered. (*See, e.g.*, Tr. 542a).

Had the court not taken that approach, Goldman, Sachs would have presented evidence that investors such as Brown Brothers regularly add and remove names from approved lists for reasons which do not relate to creditworthiness. This would have been shown to be such a common occurrence that it reasonably was not considered a warning signal by Goldman, Sachs and therefore need not have been conveyed to Franklin. This evidence was not offered because the trial court clearly indicated that Brown Brothers was not an issue in the case.

In addition to the evidence which Goldman, Sachs would have offered had it known that the Brown Brothers question was relevant, Goldman, Sachs was specifically precluded from asking Mr. Bock a critical question. After permitting Bock to testify hypothetically regarding his reaction to various facts known to Goldman, Sachs and allegedly not known to Franklin (*e.g.*, Bock, Tr. 158a), the

court refused to let Mr. Bock testify on cross-examination as to whether the knowledge that Brown Brothers had lent money to Penn Central in April 1970 would have affected his judgment. (Tr. 298a-99a). Franklin would have this Court believe that Goldman, Sachs was permitted to explore this point, arguing that Brown Brothers' participation in bank lines of credit "was brought to Mr. Bock's attention on both direct and cross-examination and had no effect on his testimony." (Appellee's Brief at 51). The fact is, however, that although the matter was "brought to his attention" on cross-examination, Bock *was not allowed to testify on the point.* (Bock, Tr. 298a-99a).

Franklin also argues that regardless of whether Brown Brothers' removal of Penn Central from its approved list had independent credit significance, the disappearance of a major purchaser of Penn Central paper eliminated a significant source of cash from the railroad's point of view. As the trial court correctly noted, however, Penn Central had no trouble selling its commercial paper in the period between the removal by Brown Brothers of Penn Central from its approved list and the time of Franklin's purchase. 406 Supp. at 45 (1458a). Hence, there is no support for the proposition that Brown Brothers' action affected Penn Central's ability to raise cash.

Finally, Franklin takes issue with the argument that Brown Brothers' $2 million loan to Penn Central in April 1970 has any significance. It claims that Brown Brothers lent that money because it had no choice and that the transaction was therefore irrelevant. As previously indicated, the testimony of the only commercial banker who testified at trial was clear that such lines of credit are cancellable. This testimony is confirmed by Exhibit BZ (1395a), a letter constituting a line of credit agreement

between Penn Central and First National Bank-Chicago, which specifically shows that its line of credit to Penn Central was cancellable at will. First National Bank-Chicago was part of the same back-up line as Brown Brothers, and thus Exhibit BZ directly refutes the vague reference by Mr. Bevan to "confirmed" lines of credit.

In sum, the trial court should have considered evidence that Brown Brothers extended a loan to Penn Central in late April, and that the addition and removal of issues from approved lists is generally not of credit significance. Furthermore, Bock himself should have been required to answer the question of whether the continued existence of Brown Brothers' line of credit to Penn Central would have affected his judgment.

* * *

The final evidentiary errors upon which Goldman, Sachs relies in this appeal were the exclusion of two instances demonstrating Goldman, Sachs' continued good faith belief in Penn Central.

As we argued in our initial brief to this Court, it appears from the opinion of the trial court and its conduct of the trial that exclusion of this evidence was made on the basis that *scienter* as recognized in *Ernst & Ernst* was not deemed to be a requisite for imposing liability. Any other interpretation of the court's opinion makes the exclusion of this evidence inexplicable—and reversible error.

Farnklin's only response to these arguments is the assertion that because different kinds of securities were involved in Goldman, Sachs' proffered evidence and because the transactions occurred subsequent to Franklin's purchase, the matters raised were irrelevant. While it is of course true that different securities were involved in

the instances as to which evidence was offered, that distinction is not material since the risk of loss existed in each case.

Similarly, the fact that the proffered evidence related in part to events occurring after Franklin's purchase hardly undercuts their significance. If Goldman, Sachs had faith in Penn Central in May 1970, then *a fortiori* it had faith in February and March.

CONCLUSION

For the foregoing reasons, the judgment of the District Court should be reversed or, in the alternative, the judgment should be vacated and the case remanded for a new trial.

Dated: August 11, 1976

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